Supreme Court, U.S.
FILED
NOV 16 1994
OFFICE OF THE CLERK

No. 94-18

# In the Supreme Court of the United States

OCTOBER TERM, 1994

ANTONIO C. MASTROBUONO, ET AL., PETITIONERS

*v.*

SHEARSON LEHMAN HUTTON, INC., ET AL.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

## BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

DREW S. DAYS, III
*Solicitor General*

LAWRENCE G. WALLACE
*Deputy Solicitor General*

MALCOLM L. STEWART
*Assistant to the Solicitor General*
*Department of Justice*
*Washington, D.C. 20530*
*(202) 514-2217*

SIMON M. LORNE
*General Counsel*

PAUL GONSON
*Solicitor*

JACOB H. STILLMAN
*Associate General Counsel*

LUCINDA O. MCCONATHY
*Assistant General Counsel*

SUSAN S. MCDONALD
*Special Counsel*

MARK PENNINGTON
*Special Counsel*
*Securities and Exchange Commission*
*Washington, D.C. 20549*

## QUESTION PRESENTED

Whether the district court erred in vacating the arbitral award of punitive damages in this case.

TABLE OF CONTENTS


| | Page |
|---|---|
| Interest of the United States and the Securities and Exchange Commission | 1 |
| Statement | 3 |
| Summary of argument | 7 |
| Argument: | |
| I. With respect to agreements between brokers and customers executed after September 7, 1989, federal law prohibits the enforcement of any contractual provision that would deprive customers of remedies that would be available in a judicial forum | 10 |
| II. The arbitrators in this case did not exceed their powers, and vacatur of the punitive damages award was therefore improper | 12 |
| A. Under the Federal Arbitration Act, a court asked to vacate an arbitral award must accord substantial deference to the arbitrator's construction of the governing agreement | 12 |
| B. The arbitrators did not exceed their powers in awarding punitive damages in this case | 19 |
| Conclusion | 29 |


TABLE OF AUTHORITIES

Cases:


| | |
|---|---|
| *Advest, Inc.* v. *McCarthy*, 914 F.2d 6 (1st Cir. 1990) | 14 |
| *Ainsworth* v. *Skurnick*, 960 F.2d 939 (11th Cir. 1992), cert. denied, 113 S. Ct. 1269 (1993) | 16 |
| *Andros Compania Maritima* v. *Marc Rich & Co., A.G.*, 579 F.2d 691 (2d Cir. 1978) | 14 |
| *Antwine* v. *Prudential Bache Sec., Inc.*, 899 F.2d 410 (5th Cir. 1990) | 14 |
| *AT&T Technologies* v. *Communications Workers*, 475 U.S. 643 (1986) | 16, 18, 20 |

Cases—Continued: Page

*Baravati* v. *Josepthal, Lyon & Ross, Inc.*, 28 F.3d 704 (7th Cir. 1994) ..... 23, 24, 27
*Barbier* v. *Shearson Lehman Hutton Inc.*, 948 F.2d 117 (2d Cir. 1991) ..... 6, 16
*Brown* v. *Rauscher Pierce Refsnes, Inc.*, 994 F.2d 775 (11th Cir. 1993) ..... 15
*City of New York* v. *FCC*, 486 U.S. 57 (1988) ..... 12
*Davis* v. *Chevy Chase Financial Ltd.*, 667 F.2d 160 (D.C. Cir. 1981) ..... 14, 15
*Federated Dep't Stores* v. *J.V.B. Indus.*, 894 F.2d 862 (6th Cir. 1990) ..... 14
*Flender Corp.* v. *Techna-Quip Co.*, 953 F.2d 273 (7th Cir. 1992) ..... 14-15
*French* v. *Merrill Lynch, Pierce, Fenner & Smith*, 784 F.2d 902 (9th Cir. 1986) ..... 15
*Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976) ..... 5, 22
*Gilmer* v. *Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991) ..... 21, 22, 24
*Hill* v. *Norfolk & Western Ry.*, 814 F.2d 1192 (7th Cir. 1987) ..... 16
*Hines* v. *Davidowitz*, 312 U.S. 52 (1941) .....
*Honda Motor Co.* v. *Oberg*, 114 S. Ct. 2331 (1994) .. 20
*Kaiser Steel Corp.* v. *Mullins*, 455 U.S. 72 (1982) .. 11
*Lee* v. *Chica*, 983 F.2d 883 (8th Cir. 1993) ..... 15
*McIlroy* v. *PaineWebber, Inc.*, 989 F.2d 817 (5th Cir. 1993) ..... 15
*Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985) ..... 20, 21, 22
*Moses H. Cone Memorial Hosp.* v. *Mercury Constr. Corp.*, 460 U.S. 1 (1983) ..... 21
*Olson* v. *Paine, Webber, Jackson & Curtis, Inc.*, 806 F.2d 731 (7th Cir. 1986) ..... 11
*Perry* v. *Thomas*, 482 U.S. 483 (1987) ..... 26
*Quinn* v. *Gulf & Western Corp.*, 644 F.2d 89 (2d Cir. 1981) ..... 11
*Rodriguez De Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989) ..... 14, 22
*Saturn Distribution Corp.* v. *Williams*, 905 F.2d 719 (4th Cir.), cert. denied, 498 U.S. 983 (1990) ..... 26



Cases—Continued: Page

*Securities Industry Assoc.* v. *Connolly*, 883 F.2d 1114 (1st Cir.), cert. denied, 495 U.S. 956 (1990) ..... 26
*Shearson/American Express, Inc.* v. *McMahon*, 482 U.S. 220 (1987) ..... 2, 10, 14, 20, 21
*Southland Corp.* v. *Keating*, 465 U.S. 1 (1984) ..... 26
*TXO Production Corp.* v. *Alliance Resources Corp.*, 113 S. Ct. 2711 (1993) ..... 20
*United Paperworkers Int'l Union, AFL-CIO* v. *Misco, Inc.*, 484 U.S. 29 (1987) ..... 13, 17
*United Steelworkers of America* v. *Enterprise Wheel & Car Corp.*, 363 U.S. 593 (1960) ..... 13, 17
*Volt Info. Sciences* v. *Board of Trustees*, 489 U.S. 468 (1989) ..... 20-21, 26, 27-28
*Webb* v. *R. Rowland & Co.*, 800 F.2d 803 (8th Cir. 1986) ..... 26
*Wilko* v. *Swan*, 346 U.S. 427 (1953) ..... 14
*Willoughby Roofing & Supply Co.* v. *Kajima Int'l, Inc.*, 598 F. Supp. 353 (N.D. Ala. 1984), aff'd, 776 F.2d 269 (11th Cir. 1985) ..... 19
*W.R. Grace & Co.* v. *Local Union 759, Int'l Union of the United Rubber Workers*, 461 U.S. 757 (1983) ..... 17

Statutes and rules:

Federal Arbitration Act, 9 U.S.C. 1 *et seq.*:
§ 9, 9 U.S.C. 9 ..... 14
§ 10(a), 9 U.S.C. 10(a) ..... 14, 15, 16, 20
§ 10(a)(4), 9 U.S.C. 10(a)(4) (1988 & Supp. V 1993) ..... 5, 7, 15, 20
Labor-Management Act, 1947, 29 U.S.C. 141 *et seq.* ..... 12
Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.* ..... 1, 2
§ 6(b)(6), 15 U.S.C. 78f(b)(6) ..... 10
§ 15A, 15 U.S.C. 78*o*-3 ..... 1
§ 15A(b)(6), 15 U.S.C. 78*o*-3(b)(6) ..... 10, 12
§ 15(b)(8), 15 U.S.C. 78*o*(b)(8) ..... 2
§ 19(g)(1), 15 U.S.C. 78s(g)(1) ..... 10, 12
§ 28(a), 15 U.S.C. 78bb(a) ..... 4
§ 29(a), 15 U.S.C. 78cc(a) ..... 10

| Rules—Continued: | Page |
|---|---|
| AMEX Rule 427 | 6 |
| NASD Code of Arbitration Procedure, Section 41(e) | 24 |
| NASD R. of Fair Practice: | |
| Rule 21(f) | 6 |
| Rule 21(f)(4) | 6, 7, 10, 11, 12, 21 |
| NYSE Rule 636 | 6 |
| **Miscellaneous:** | |
| Note, Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the "Manifest Disregard" of the Law Standard, 27 Ind. L. Rev. 241 (1993) | 15 |
| Order Approving Proposed Rule Changes by the NYSE, NASD and AMEX Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Comm. Rel. No. 34-26805, 54 Fed. Reg. 21,144 (1989) | 2 |
| p. 21,144 | 6 |
| p. 21,145 | 2, 6 |
| p. 21,153 | 3 |
| p. 21,154 | 10, 21 |
| Restatement (Second) of Contracts | 25 |
| S. Rep. No. 75, 94th Cong., 1st Sess. (1975) | 10-11 |


# In the Supreme Court of the United States

OCTOBER TERM, 1994

---

No. 94-18

ANTONIO C. MASTROBUONO, ET AL., PETITIONERS

*v.*

SHEARSON LEHMAN HUTTON, INC., ET AL.

---

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT*

---

## BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

---

### INTEREST OF THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION

This case involves a dispute between a securities broker-dealer and two of its customers, which was arbitrated pursuant to a pre-dispute arbitration agreement under the rules of the National Association of Securities Dealers, Inc. (NASD).[1] The issue

---

[1] The NASD is registered with the Securities and Exchange Commission as a national securities association under Section 15 A of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3. It is the only such registered national securities association. Subject to comprehensive oversight by the Commission, the NASD has primary responsibility under the Act for regulation of those who sell securities in the over-the-counter mar-

is whether a choice-of-law provision in the arbitration agreement precluded the customers from obtaining punitive damages—a remedy that would have been available to them if their claims had been resolved in court rather than arbitration.

As part of its regulatory mandate under the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*, the Securities and Exchange Commission has the responsibility for overseeing and approving the rules of the NASD and other self-regulatory organizations (SROs), such as the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEl), to assure that they adequately protect the rights of customers. See *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 233-234 (1987). This oversight extends to the administration of arbitration systems by the NASD, NYSE, AMEX and other SROs.[2] The arbitration systems operated by the NASD and other SROs pursuant to rules approved by the Commission play an important role in investor protection by affording brokerage

---

ket. By virtue of Section 15(b)(8) of the Exchange Act, 15 U.S.C. 78o(b)(8), all broker-dealers that deal with retail customers in non-exempt securities must belong to the NASD.

[2] In addition to the NASD, NYSE, and AMEX, the Municipal Securities Rulemaking Board, Pacific Stock Exchange, Chicago Stock Exchange (formerly the Midwest Stock Exchange), Boston Stock Exchange, Chicago Board Options Exchange, Cincinnati Stock Exchange and Philadelphia Stock Exchange also administer arbitration programs. See Order Approving Proposed Rule Changes by the NYSE, NASD and AMEX Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Comm. Rel. No. 34-26805, 54 Fed. Reg. 21,144, 21,145 n.7 (1989) (hereinafter 1989 Release).



firm customers a simple, quick, and inexpensive means of redress. A large percentage of customer accounts with securities broker-dealers are subject to account agreements that require arbitration of disputes between the parties.[3] The Commission has a substantial interest in ensuring that arbitration agreements between brokerage firms and their customers comply with applicable SRO rules, including rules that require that arbitration not be used as a means to deprive customers of remedies that would be available in a judicial forum. The Commission is also concerned that arbitration not be made more complex, time-consuming, and expensive by failure to adhere to the fundamental principle that construction of an arbitration contract is for the arbitrators, not the courts, and that arbitration agreements be interpreted in a manner consistent with the Federal Arbitration Act.

The United States has a similar interest, in other litigation contexts, in the correct interpretation and application of the Federal Arbitration Act and in the effectiveness of the arbitral remedies authorized by that Act.

## STATEMENT

In 1985 petitioners, Illinois residents, became customers of respondent Shearson Lehman Hutton, Inc., a securities broker-dealer firm and member of the

---

[3] See 1989 Release, 54 Fed. Reg. at 21,153 n. 51, which reported the results of a 1988 Commission study of 65 broker-dealer firms representing 90% of all customer trading accounts in the United States. According to that study, 96% of the margin accounts, 95% of the options accounts, and 39% of the cash accounts were subject to pre-dispute arbitration agreements.

NASD. The customer agreement executed by petitioners and the firm provided, in relevant part, that

> [the agreement] shall be governed by the laws of the State of New York. * * * [A]ny controversy arising out of or relating to [the petitioners'] accounts * * * shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as [the petitioners] may elect.

Pet. App. 44.

In January 1989 petitioners filed suit in the United States District Court for the Northern District of Illinois against Shearson and respondent Nick DiMinico, the Shearson employee who handled their account. Petitioners' complaint alleged unauthorized trading, churning, and margin exposure in their account. Petitioners sought compensatory damaages under federal securities law, as well as compensatory and punitive damages under state law.[4] In April 1989 respondents filed a motion to compel arbitration, which the district court granted. Pet. App. 3-4.

Petitioners commenced arbitration before the NASD. Their complaint alleged violations of the NASD Rules of Fair Practice, the Securities Exchange Act, SEC Rule 10b-5, the Illinois Consumer Fraud Act, and the Texas Deceptive Trade Practices-Consumer Protection Act. Petitioners also alleged breach of fiduciary duty and negligence. Hearings

[4] Punitive damages are not available under the Exchange Act. See 15 U.S.C. 78bb(a).



were conducted before a panel of three arbitrators in August and September 1992. Respondents contended, *inter alia*, that the arbitrators had no authority to award punitive damages. In October 1992 the arbitrators awarded the petitioners approximately $160,000 in compensatory damages and $400,000 in punitive damages. Pet. App. 4-5.

Respondents then moved in federal district court for vacatur of the punitive damages award. Petitioners moved to confirm the award; in the alternative, they contended that their claim for punitive damages should be tried before the district court. Pet. App. 5-6. The district court granted respondents' motion to vacate. Under New York law, the court noted, the power to award punitive damages is reserved to the courts and may not be exercised by arbitrators. *Id.* at 33 (citing *Garrity* v. *Lyle Stuart, Inc.*, 353 N.E.2d 793, 794 (N.Y. 1976)). The court concluded that "[b]ecause the [petitioners] agreed to arbitrate their dispute in accordance with laws of the State of New York, and because the Agreement does not explicitly or by incorporation authorize the award of punitive damages, the remedies available to them are limited by the *Garrity* rule." Pet. App. 38-39.

The court of appeals affirmed. Pet. App. 1-27. The court of appeals first rejected petitioners' contention that the district court had reviewed the arbitral award under an insufficiently deferential standard.[5] The court acknowledged that "[t]he arbitrator's errors of law and contract construction are normally

[5] Section 10(a)(4) of the Federal Arbitration Act, 9 U.S.C. 10(a)(4) (1988 & Supp. V 1993), provides that an arbitral award may be vacated if, *inter alia*, "the arbitrators exceeded their powers."

unreviewable," but asserted that the "narrow scope of review does not immunize an award clearly unauthorized by the terms of the agreement." Pet. App. 8. The court concluded that "where the arbitrators are not entitled to award punitive damages due to a choice of law provision in the parties' agreement, it is 'manifest' that the arbitrators would exceed their powers by awarding punitive damages." *Id.* at 8-9 (citing *Barbier* v. *Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991)).

The court of appeals next held that the inclusion in the arbitration agreement of a choice-of-law clause referencing New York law precluded an arbitral award of punitive damages. The court stated that "[b]ecause any condition imposed by New York law can be found in the books, a choice of law provision suffices to incorporate the *Garrity* rule." Pet. App. 14. The court rejected petitioners' argument that Rule 21(f)(4) of the NASD Rules of Fair Practice required a different outcome. That Rule provides:

> No agreement [between a member and a customer] shall include any condition which * * * limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award.[6]

---

[6] NASD Rule 21(f) was developed under the auspices of the Securities Industry Conference on Arbitration (SICA), which was formed in 1977 to work with the Commission to monitor and improve the system of SRO arbitration. See 1989 Release, 54 Fed. Reg. at 21,144-21,145. The relevant provisions of the rules of the NYSE and the AMEX are substantially identical to the NASD Rule discussed here. Compare NASD Art. III, Rule 21(f) of the NASD's Rules of Fair Practice with NYSE Rule 636 and AMEX Rule 427.



The court held that "[t]o the extent that this provision conflicts with New York law, the governing law of the agreement under all the circumstances, we must conclude that the parties intended to be bound by New York law." Pet. App. 17.

## SUMMARY OF ARGUMENT

1. NASD Rule 21(f)(4) forbids the inclusion in broker-client arbitration agreements of provisions limiting the ability of arbitrators to award relief that would be available in a judicial forum. That Rule has an effective date of September 7, 1989; with respect to agreements executed after that date, the Rule has the force of federal law and precludes the enforcement of contractual provisions that are inconsistent with its terms. With respect to agreements (such as the contract at issue here) signed on or before September 7, 1989, Rule 21(f)(4) does not apply. This case consequently presents a question of contract interpretation, not of preemption by federal securities law. Regardless of the resolution of this case, however, it is important that the Court leave no confusion as to the operation of Rule 21(f)(4) with respect to agreements signed after the Rule's effective date.

2. The arbitrators in this case did not "exceed[] their powers" within the meaning of 9 U.S.C. 10(a)(4). The arbitral award of punitive damages should therefore have been confirmed.

a. Under the Federal Arbitration Act, a losing party is not entitled to appeal the arbitrator's decision on grounds of legal error. Although the Act permits a court to vacate an arbitral award under certain narrow circumstances, judicial review under

the statute must reflect substantial deference to the arbitrator's construction of an ambiguous agreement. As this Court has recognized in decisions under the federal labor statutes, the arbitrator's discretion is particularly broad—and judicial interference with the exercise of that discretion particularly inappropriate—in the formulation of appropriate remedies. While the court of appeals purported to respect the stringent limitations on its reviewing authority, its decision to affirm the vacatur of the arbitral award was based in essence on its belief that the arbitrator had misconstrued the contract. That belief provides a fundamentally inadequate basis for vacatur: The essence of arbitration is the parties' agreement that the arbitrator rather than the courts will be entrusted with the task of interpreting their contract.

b. The arbitral award of punitive damages in this case was based on an entirely reasonable reading of the parties' agreement. As this Court has repeatedly emphasized, an agreement to arbitrate ordinarily has the consequence only of changing the forum in which a dispute is to be resolved; it does not entail a waiver of substantive rights. This Court has also stressed that the FAA was intended to counteract prior hostility to arbitration as a means of dispute resolution. The *Garrity* rule, by contrast, rests largely on the mistrust of arbitrators that the FAA has rejected, and its application would transform the agreement to arbitrate into a surrender of substantive rights. The parties are unquestionably permitted (insofar as the FAA is concerned) to agree to such constraints on the arbitrator's remedial power. Because the *Garrity* rule runs counter to the premises underlying the FAA, however, such an agreement should



not be inferred by the courts (as a basis for vacating an arbitration award) absent an unambiguous indication that this was the parties' intent.

The agreement at issue in this case provides no clear indication that the parties intended to preclude an award of punitive damages. Although the agreement referenced the law of New York, it was plainly within the contemplation of the parties that other bodies of law (most obviously the federal securities laws) might be consulted in the process of resolving any disputes that might arise. The agreement expressly provided that any arbitral proceedings would be conducted in accordance with the rules of the NASD; and those rules do not restrict the types of relief an arbitrator may award. In our view, these provisions are most reasonably harmonized by applying New York law to determine what substantive rights and obligations are created by the contract, while applying NASD rules to resolve questions concerning the conduct of the arbitral proceedings and the scope of the arbitrators' authority. We note as well that the *Garrity* rule would clearly be preempted if the agreement contained no choice-of-law clause and New York law applied on the basis of the State's connection to the parties, the contract, and the contested transactions. The choice-of-law clause in this agreement should not be read to incorporate state law principles that would be preempted if New York law applied of its own force as a result of the State's connection to the relevant primary conduct.

## ARGUMENT

### I. WITH RESPECT TO AGREEMENTS BETWEEN BROKERS AND CUSTOMERS EXECUTED AFTER SEPTEMBER 7, 1989, FEDERAL LAW PROHIBITS THE ENFORCEMENT OF ANY CONTRACTUAL PROVISION THAT WOULD DEPRIVE CUSTOMERS OF REMEDIES THAT WOULD BE AVAILABLE IN A JUDICIAL FORUM

Rule 21(f)(4) of the NASD Rules of Fair Practice prohibits member firms from including in their customer agreements any contractual provision that "limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award." As explained by the Commission when it approved the Rule,

> [t]his provision makes clear that the use of arbitration for the resolution of investor/broker-dealer disputes represents solely a choice of arbitration as a means of dispute resolution. Agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum. If punitive damages * * * would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them.

1989 Release, 54 Fed. Reg. at 21,154. NASD Rule 21(f)(5) provides that "[t]he requirements of subparagraphs (f)(1) through (4) shall apply only to new agreements signed by an existing or new customer of a member after September 7, 1989."

With respect to contracts executed after September 7, 1989, Rule 21(f)(4)—like the rules of SROs generally—carries the force of federal law. See, *e.g.*, 15 U.S.C. 78f(b)(6), 78*o*-3(b)(6), 78s(g)(1), and 78cc(a); *McMahon*, 482 U.S. at 233-234; S. Rep. No. 75, 94th Cong., 1st Sess. 24 (1975) (noting that SROs "must exercise governmental-type powers if they are to carry out their responsibilities under the Exchange Act"). It is well established that "illegal promises will not be enforced in cases controlled by the federal law." *Kaiser Steel Corp.* v. *Mullins*, 455 U.S. 72, 77, 85-86 (1982). Accord *Quinn* v. *Gulf & Western Corp.*, 644 F.2d 89, 91 (2d Cir. 1981) (court would not enforce contract provision to pay contingent fee that violated federal procurement statute and regulation).[7] Rule 21(f)(4) would therefore preclude enforcement, with respect to agreements executed after its effective date, of a contractual provision that prevents arbitrators from awarding punitive damages when such damages would be available in a judicial forum in the relevant State.

The court of appeals' opinion reflects some confusion regarding the legal significance of the NASD Rules. The court stated, for example, that "[t]o the extent that [Rule 21(f)(4)] conflicts with New York law, the governing law of the agreement under all circumstances, we must conclude that the parties intended to be bound by New York law." Pet. App. 17. See also *id.* at 20 ("We resolve any apparent conflict between New York law and NASD rules in favor of New York law, the generally applicable law of the agreement."). With respect to contracts executed

---

[7] This principle is subject to exceptions not relevant here. See, *e.g.*, *Olson* v. *Paine, Webber, Jackson & Curtis, Inc.*, 806 F.2d 731, 743 (7th Cir. 1986) (recognizing general principle that illegal contract terms will not be enforced, but enforcing contractual provision that violated a Commodity Futures Trading Commission (CFTC) regulation because to do so would not harm a party the regulation was intended to protect and failing to enforce the contract would "produce a sanction disproportionate to the wrong").

after September 7, 1989, that mode of analysis would clearly be wrong. Private parties have no authority to enter into contractual arrangements that are forbidden by federal law, or to agree that federal regulations will be superseded by contrary state law. To permit enforcement of such provisions in new brokerage agreements would undermine the ability of the NASD to carry out its responsibilities under the Exchange Act to adopt and enforce rules consistent with the Act to regulate the conduct of their member broker-dealer firms and associated persons. See 15 U.S.C. 78*o*-3(b)(6) (NASD Rules must be designed "to promote just and equitable principles of trade * * * and, in general, to protect investors and the public interest"); 15 U.S.C. 78s(g)(1). Cf. *City of New York* v. *FCC*, 486 U.S. 57 (1988).

The arbitration agreement at issue in the present case was executed in 1985, well before the promulgation of Rule 21(f)(4). This case therefore presents a question of contract interpretation, not of preemption by federal securities law. Regardless of the resolution of this case, however, it is important that the Court leave no confusion as to the operation of Rule 21(f)(4) with respect to agreements signed after the Rule's effective date.

## II. THE ARBITRATORS IN THIS CASE DID NOT EXCEED THEIR POWERS, AND VACATUR OF THE PUNITIVE DAMAGES AWARD WAS THEREFORE IMPROPER

### A. Under The Federal Arbitration Act, A Court Asked To Vacate An Arbitral Award Must Accord Substantial Deference To The Arbitrator's Construction Of The Governing Agreement

In reviewing arbitral decisions under the Labor-Management Relations Act, 1947, this Court has consistently made clear that "the question of interpretation of the collective bargaining agreement is a question for the arbitrator. It is the arbitrator's construction which was bargained for; and so far as the arbitrator's decision concerns construction of the contract, the courts have no business overruling him because their interpretation of the contract is different from his." *United Steelworkers of America* v. *Enterprise Wheel & Car Corp.*, 363 U.S. 593, 599 (1960). In *United Paperworkers Int'l Union, AFL-CIO*, v. *Misco, Inc.*, 484 U.S. 29 (1987), the Court recently reaffirmed that

> [b]ecause the parties have contracted to have disputes settled by an arbitrator chosen by them rather than by a judge, it is the arbitrator's view of the facts and of the meaning of the contract that they have agreed to accept. Courts thus do not sit to hear claims of factual or legal error by an arbitrator as an appellate court does in reviewing decisions of lower courts. * * * The arbitrator may not ignore the plain language of the contract; but the parties having authorized the arbitrator to give meaning to the language of the agreement, a court should not reject an award on the ground that the arbitrator misread the contract.

*Id.* at 37-38.

These principles are equally applicable to review of arbitral awards pursuant to the Federal Arbitration Act.[8] The Act does not empower a losing party to appeal the arbitrator's decision on grounds of legal error. Rather, the statute provides that the prevail-

[8] Indeed, this Court has noted that "the federal courts have often looked to the [Federal Arbitration] Act for guidance in labor arbitration cases." *Misco*, 484 U.S. at 40 n.9.

ing party may seek a judicial order confirming the award, "and thereupon the court must grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title." 9 U.S.C. 9. Section 10(a) of the Act, 9 U.S.C. 10(a), *quoted at* Pet. 4-5, sets forth narrow grounds for vacatur of an award governed by the statute. Although this Court has not had occasion to address in detail the standards governing application of this provision,[9] the courts of appeals have repeatedly emphasized that the grounds for vacatur are to be narrowly construed and that a court may not refuse to confirm an award simply because it disagrees with the arbitrator's construction of the contract.[10]

---

[9] In *Wilko* v. *Swan*, 346 U.S. 427 (1953), the Court observed that under the FAA "the interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation. The United States Arbitration Act contains no provision for judicial determination of legal issues such as is found in the English law." *Id.* at 436-437 (footnote omitted). The specific holding of *Wilko*—that predispute agreements to arbitrate claims under the Securities Act of 1933 are not enforceable—has since been overruled. See *Rodriguez De Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477 (1989). The Court has continued to recognize, however, that under the FAA "judicial scrutiny of arbitration awards necessarily is limited." *Shearson/American Express Inc.* v. *McMahon*, 482 U.S. 220, 232 (1987).

[10] See, *e.g.*, *Davis* v. *Chevy Chase Financial Ltd.*, 667 F.2d 160, 165 (D.C. Cir. 1981); *Advest, Inc.* v. *McCarthy*, 914 F.2d 6 (1st Cir. 1990); *Andros Compania Maritima* v. *Marc Rich & Co., A.G.*, 579 F.2d 691, 704 (2d Cir. 1978); *Antwine* v. *Prudential Bache Sec., Inc.*, 899 F.2d 410, 413 (5th Cir. 1990); *Federated Dep't Stores* v. *J.V.B. Indus.*, 894 F.2d 862, 866 (6th Cir. 1990); *Flender Corp.* v. *Techna-Quip Co.*, 953 F.2d 273, 278 (7th Cir. 1992); *Lee* v. *Chica*, 983 F.2d 883, 885 (8th Cir. 1993); *French* v. *Merrill Lynch, Pierce, Fenner & Smith*, 784 F.2d 902, 906 (9th Cir. 1986).

There is, we acknowledge, some divergence among the circuits with respect to the standards governing vacatur of arbitral awards under the FAA. The courts of appeals have disagreed, for example, as to the propriety of vacatur on grounds other than those specified in Section 10(a). See generally *McIlroy* v. *PaineWebber, Inc.*, 989 F.2d 817, 820 & n.2 (5th Cir. 1993); *Brown* v. *Rauscher Pierce Refsnes, Inc.*, 994 F.2d 775, 779 & n.3 (11th Cir. 1993); Note, Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the "Manifest Disregard" of the Law Standard, 27 Ind. L. Rev. 241 (1993). For purposes of the instant case, however, those areas of disagreement are less important than is the uniform consensus that judicial review of an arbitral award under the FAA must reflect substantial deference to the arbitrator's construction of an ambiguous agreement. See *Davis*, 667 F.2d at 166 ("Although various tests have been employed in implementation of this broad standard, it is apparent that the arbitrator's award should not be upset in such a case if it represents a plausible interpretation of the contract.").



In the instant case the court of appeals acknowledged that "[t]he arbitrator's errors of law and contract construction are normally unreviewable under [9 U.S.C. 10(a)(4)]." Pet. App. 8. (Section 10(a)(4) states that an arbitral award may be vacated if, *inter alia*, the arbitrators "exceeded their powers.") The court asserted, however, that the "narrow scope of review does not immunize an award clearly unauthorized by the terms of the agreement." *Ibid.* That reasoning provides no basis for vacatur of the award in the instant case. In the first place, it is by no means apparent that even "clear" error in the interpretation of the contract constitutes a ground

for vacatur under Section 10(a).[11] In any event, as we explain in Point B, *infra*, there is no basis for the court of appeals' conclusion that the arbitral award of punitive damages was "clearly unauthorized" by the parties' agreement.

The court of appeals also asserted that "where the arbitrators are not entitled to award punitive damages due to a choice of law provision in the parties' agreement, it is 'manifest' that the arbitrators would exceed their powers by awarding punitive damages." Pet. App. 8-9 (quoting *Barbier* v. *Shearson Lehman Hutton Inc.*, 948 F.2d 117, 122 (2d Cir. 1991)). Although that language is not entirely clear, it appears to suggest that the question whether a contract authorizes the award of a discrete category of relief is to be resolved by the court de novo, on the theory that an arbitrator exceeds his powers by awarding a remedy that the agreement does not in fact permit. That

---

[11] Compare *Ainsworth* v. *Skurnick*, 960 F.2d 939, 941 (11th Cir. 1992) ("although great deference is normally accorded an arbitration award, an award that is arbitrary or capricious is not required to be enforced"), cert. denied, 113 S. Ct. 1269 (1993) with *Hill* v. *Norfolk & W. Ry.*, 814 F.2d 1192, 1194-1195 (7th Cir. 1987) (under either the FAA or the labor statutes, "the question for decision by a federal court asked to set aside an arbitral award * * * is not whether the arbitrator or arbitrators erred in interpreting the contract; it is not whether they grossly erred in interpreting the contract; it is whether they interpreted the contract"). Cf. *AT&T Technologies* v. *Communications Workers*, 475 U.S. 643, 649-650 (1986) ("Whether 'arguable' or not, indeed even if it appears to the court to be frivolous, the union's claim that the employer has violated the collective-bargaining agreement is to be decided, not by the court asked to order arbitration, but as the parties have agreed, by the arbitrator.").



theory is contrary to this Court's precedents.[12] In *Enterprise Wheel* the Court considered a closely analogous question. The arbitrator in that case found that employees had been discharged in violation of the collective bargaining agreement; he ordered reinstatement and back pay extending beyond the expiration of the contract. The court of appeals vacated the award insofar as it provided relief for the period after the contract's expiration. This Court reversed. The Court observed that the agreement "could have provided that if any of the employees were wrongfully discharged, the remedy would be reinstatement and back pay up to the date they were returned to work." 363 U.S. at 598. The employer's attack on the arbitral award, the Court recognized, boiled down to the assertion that the contract, properly construed, did not so provide. *Ibid.* The Court rejected that contention, explaining that "[i]t is the arbitrator's construction which was bargained for; and so far as the arbitrator's decision concerns construction of the contract, the courts have no business overruling him because their interpretation of the contract is different from his." *Id.* at 599. That same principle applies here.[13]

---

[12] Indeed, in the context of labor arbitration, this Court has emphasized that the arbitrator's discretion is particularly broad—and judicial interference with the exercise of that discretion particularly inappropriate—"when it comes to formulating remedies." *Misco*, 484 U.S. at 41 (quoting *Enterprise Wheel*, 363 U.S. at 597).

[13] Cf. *W.R. Grace & Co.* v. *Local Union 759, Int'l Union of the United Rubber Workers*, 461 U.S. 757, 765 (1983) ("Because the authority of arbitrators is a subject of collective bargaining, just as is any other contractual provision, the scope of the arbitrator's authority is itself a question of con-

Nor can a de novo standard of review be defended on the ground that "the question of arbitrability—whether a collective-bargaining agreement creates a duty for the parties to arbitrate the particular grievance—is undeniably an issue for judicial determination." *AT&T Technologies* v. *Communications Workers*, 475 U.S. 643, 649 (1986). The dispute here does not involve an issue of arbitrability. Rather, as the court of appeals correctly noted, "[t]he Client Agreement does not purport to withhold certain issues from arbitration. In fact, it refers all 'controvers[ies]' to arbitration." Pet. App. 18. The dispute concerns the legal framework governing the arbitrator's decision whether punitive damages should be awarded. Respondents contend that the choice-of-law clause, properly construed to incorporate the rule announced in *Garrity*, disentitled the arbitrator to award punitive damages under any circumstances. Possibly the arbitrators in this case could have construed the contract in that manner, although they did not. But, in any event, that contention concerning the meaning of the contract does not amount to a contention that petitioners' punitive damages claims are non-arbitrable. Cf. *AT&T Technologies*, 475 U.S. at 649 ("in deciding whether the parties have agreed to submit a particular grievance to arbitration, a court is not to rule on the potential merits of the underlying claims").

---

tract interpretation that the parties have delegated to the arbitrator."). As we explain at pages 18-19, *infra*, questions concerning the scope of the arbitrator's authority with respect to matters conceded to be arbitrable must be distinguished from issues of arbitrability—*i.e.*, whether a particular claim is to be resolved by the arbitrator or by a court.



Indeed, any suggestion that petitioners' punitive damages claims are non-arbitrable would be fundamentally at odds with the basic premises underlying respondents' legal position. Petitioners initially filed suit in federal district court, including in their complaint a request for punitive damages. Respondents then moved to compel arbitration of the entire case, and the district court granted the motion. Pet. App. 3-4. Referral of the punitive damages claims to the arbitrators obviously served respondents' interests, since the incorporation of New York law into the parties' agreement could have posed no conceivable barrier to a punitive damages award if the issue had been adjudicated by the district court. Now that the arbitrators have concluded that the agreement did not in fact preclude an award of punitive damages, respondents may not evade that holding on the ground that the availability of such damages was not an arbitrable issue after all. Cf. *Willoughby Roofing & Supply Co.* v. *Kajima Int'l, Inc.*, 598 F. Supp. F. Supp. 353, 356-359 & n.12 (N.D. Ala. 1984), aff'd, 776 F.2d 269 (11th Cir. 1985).

### B. The Arbitrators Did Not Exceed Their Powers In Awarding Punitive Damages In This Case

For the reasons that follow, the courts below erred in concluding that the arbitrators had exceeded their powers in awarding punitive damages on petitioners' state law claims. In our view, the most persuasive reading of the agreement between the parties in this case is that an arbitral award of punitive damages is permitted where such relief would be available in a judicial forum. In any event, however, the arbitrators' construction of the governing contract as permitting punitive damages is surely a reasonable one, and is entitled to deference under the principles dis-

cussed in Point A, *supra*. The arbitral award therefore should have been confirmed.[14]

1. In construing an arbitration agreement within the coverage of the FAA, as with any other contract, the parties' intentions control. Those intentions are to be determined, however, by reading the agreement in light of the policies underlying the Act. See, *e.g.*, *Volt Info. Sciences* v. *Board of Trustees*, 489

[14] The Due Process Clause imposes two limitations on the amount of punitive damages that may be awarded in a judicial proceeding: a substantive ban on punitive damages that are "grossly excessive," *TXO Production Corp.* v. *Alliance Resources Corp.*, 113 S. Ct. 2711, 2718-2719 (1993) (plurality opinion); *id.* at 2731 (O'Connor, J., dissenting), and a procedural requirement that judicial review of the amount of punitive damages awards be available, see *Honda Motor Co.* v. *Oberg*, 114 S. Ct. 2331, 2335-2342 (1994). By executing an arbitration agreement governed by the FAA, however, a party consents to the limitations on judicial review established by 9 U.S.C. 10(a); "[i]t trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration." *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985). Enforcement of the parties' procedural bargain therefore raises no constitutional concerns.

It is far from clear, moreover, that the judicial review provided by Section 10(a) is in fact less extensive than the review required by the Constitution where punitive damages are awarded by a jury. An arbitrator who awards punitive damages in an amount that is "grossly excessive" within the meaning of the constitutional limitation recognized in *TXO Production* might well be said to have "exceeded [his] powers" under 9 U.S.C. 10(a)(4). An arbitrator would also be bound by any limitations on punitive damages that are imposed by the law that creates the claim. In the present case, the arbitrators awarded compensatory damages of approximately $160,000 and punitive damages of $400,000. Because respondents do not contest the size of the punitive damages award, the issue is not presented in this case.



U.S. 468, 475-476 (1989) ("in applying general state-law principles of contract interpretation to the interpretation of an arbitration agreement within the scope of the Act, due regard must be given to the federal policy favoring arbitration"). The Court has noted, for example, that in deciding the issue of arbitrability, "[t]he Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." *Moses H. Cone Memorial Hosp.* v. *Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983). Accord *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985); cf. *AT&T Technologies*, 475 U.S. at 650 ("where the [collective bargaining agreement] contains an arbitration clause, there is a presumption of arbitrability" with respect to a particular grievance).

Two aspects of federal policy under the FAA are of particular relevance here. First, this Court has repeatedly emphasized that "[b]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum." *Gilmer* v. *Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26 (1991); *McMahon*, 482 U.S. at 229-230; *Mitsubishi*, 473 U.S. at 628.[15] Second, the Court has stressed that the pur-

[15] The principle that the decision to arbitrate is not a surrender of substantive rights that would be available in a judicial forum also underlies NASD Rule of Fair Practice 21(f)(4). As the Commission's Approval Order put it, Rule 21(f)(4) "makes clear that the use of arbitration for the resolution of investor/broker-dealer disputes represents solely a choice of arbitration as a means of dispute resolution," not a decision to surrender "any rights that a party may other-

pose of the FAA "was to reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts." *Gilmer*, 500 U.S. at 24. This Court has thus explained that "[w]e are well past the time when judicial suspicion of the desirability of arbitration and the competence of arbitral tribunals inhibited the development of arbitration as an alternative means of dispute resolution." *Id.* at 34 n. 5 (quoting *Mitsubishi*, 473 U.S. at 628). See also *id.* at 30 (noting that generalized attacks on submitting statutory claims to arbitration "'res[t] on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants,' and as such, they are 'far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes'") (quoting *Rodriguez De Quijas* v. *Shearson/American Express, Inc.*, 490 U.S. 477, 481 (1989)). Accord *McMahon*, 482 U.S. at 231-234.

For a court, as a basis for vacating an arbitration award, itself to construe an ambiguous arbitration agreement as incorporating the rule announced in *Garrity* would be contrary to both of the foregoing principles. The *Garrity* court reasoned that "[t]he evil of permitting an arbitrator whose selection is often restricted or manipulatable by the party in a superior bargaining position, to award punitive damages is that it displaces the court and the jury, and therefore the State, as the engine for imposing a social sanction." 353 N.E.2d at 796. As the Seventh Circuit itself recognized in an opinion subsequent to its decision in this case, *Garrity* is based in large

---

wise have had in a judicial forum." 1989 Release, 54 Fed. Reg. at 21,154.



part on the "mistrust of arbitrators" that this Court has emphatically rejected. See *Baravati* v. *Josepthal, Lyon & Ross, Inc.*, 28 F.3d 704, 710-711 (7th Cir. 1994). The necessary consequence of the *Garrity* rule, moreover, is that execution of an arbitration agreement entails not simply consent to an alternative forum, but a waiver of substantive rights as well. Insofar as the FAA is concerned, the parties are assuredly *permitted* to agree to such constraints on the arbitrator's remedial power, just as they are permitted to fashion an arbitration agreement that reserves most potential disputes for judicial resolution. Because such contractual terms run counter to the premises underlying the FAA, however, they should not be inferred by the courts absent an unambiguous indication that this was the parties' intent.

2. For the reasons that follow, no such clear statement is present in this case.

a. The court of appeals asserted that "the parties agreed to arbitrate all of their controversies under New York law," Pet. App. 12, and that "[s]ubmission to New York law is a general condition upon the arbitration of all 'controvers[ies]' between the parties." *Id.* at 13-14. The agreement provides that it "shall be governed by the laws of the State of New York," *id.* at 44, and presumably New York law defines the rights and obligations established by the contract itself. It is clear, however, that New York law was not intended to govern every aspect of all disputes between the parties. Respondents do not contend, for example, that the arbitrator was required to apply New York law in ruling on petitioners' claims under the Securities Exchange Act or SEC Rule 10b-5. Petitioners also asserted claims based upon Illinois and Texas statutes, see Pet. App.

4, and neither of the courts below suggested that those claims were barred by the choice-of-law provision. Although the agreement was to be "governed" by the law of New York, it was plainly within the contemplation of the parties that other sources of law might be consulted in the process of resolving any disputes that might arise.

b. In this case, the arbitration agreement not only contained the New York choice-of-law provision, but it also provided that arbitration would be conducted "in accordance with the rules then in effect, of the [NASD]." Pet. App. 44. The NASD Code of Arbitration Procedure does not restrict the types of relief an arbitrator may award, but merely refers to "damages and other relief." NASD Code of Arbitration Procedure, Section 41(e) (*quoted at* Pet. App. 15). See *Gilmer*, 500 U.S. at 30 (suggesting that nearly identical language in New York Stock Exchange Rules allows a broad range of types of relief); see also *Baravati*, 28 F.3d at 710 ("Silence [about the scope of arbitrators' powers] implies—given the tradition of allowing arbitrators flexible remedial discretion—the absence of categorical limitations."). As the court of appeals in the instant case acknowledged, moreover, the NASD Manual for arbitrators specifically advises that punitive damages are a permissible remedy. Pet. App. 15.

The court of appeals acknowledged that the pertinent provisions of the Code and Manual are at least to some extent inconsistent with *Garrity*. The court resolved that tension by treating the New York law provision as the most significant provision in the agreement and then using it to trump the NASD rules. There is, in our view, no warrant in the language of the contract for concluding that the arbitrators were compelled to adopt that approach. Both the choice-of-law provision and the provision incorporating NASD rules identify bodies of law that are to be relied on in settling disputes between the broker-dealer and its customers. One provision may not be read out of the agreement when there is a reasonable interpretation of the paragraph that accommodates both.



Indeed, in our view, these provisions are most reasonably harmonized by applying New York law to determine what substantive rights and obligations are created by the contract, while applying NASD rules to resolve questions concerning the conduct of the arbitral proceedings and the scope of the arbitrators' authority. That reading comports with the established principles of contract interpretation that different provisions of an agreement should be read as consistent with each other if that is reasonably possible, that an interpretation giving effect to all the terms is preferred to one which leaves some of no effect, and that the specific (*i.e.*, NASD rules applicable to arbitration) prevails over the general (*i.e.*, the provision referencing New York law). See, *e.g.*, Restatement (Second) of Contracts § 202(5) & Cmt. d (reading different provisions as consistent with each other); *id.* § 203(a) & Cmt. b (giving effect to all terms); *id.* § 203(c) & Cmt. e (specific over general) (1981).[16]

---

[16] Moreover, it is well established that in choosing among the reasonable meanings of the terms of an agreement, "that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds." Restatement (Second) of Contracts § 206. The contract here is a form agreement drafted by respondents.

In any event, as we have explained (see pages 12-19, *supra*), the dispositive point is that the task of harmonizing apparently inconsistent contractual provisions is the province of the arbitrator rather than the courts. For the reasons explained in the preceding paragraph, the arbitrators in this case acted well within their province.

c. If the agreement in this case had contained no choice-of-law provision, the arbitrators would presumably have assessed the parties' rights and obligations under the contract by reference to the law of some State, chosen on the basis of its connection to the parties, the agreement, and the contested transactions. If that State had been New York, however, it seems clear that the *Garrity* rule would not have been applied. State law is preempted "to the extent that it actually conflicts with federal law—that is, to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" *Volt*, 489 U.S. at 477 (quoting *Hines* v. *Davidowitz*, 312 U.S. 52, 67 (1941)).[17] The *Garrity* rule, which is premised on the mistrust of arbitrators that the FAA was intended to counteract,

[17] For example, the FAA "pre-empts state laws which 'require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.'" *Volt*, 489 U.S. at 478 (quoting *Southland Corp.* v. *Keating*, 465 U.S. 1, 10 (1984)); *Perry* v. *Thomas*, 482 U.S. 483, 489-490 (1987). Similarly, States may not impose conditions on arbitration agreements that are not imposed generally on other types of contracts. *Saturn Distribution Corp.* v. *Williams*, 905 F.2d 719, 723-724 (4th Cir.), cert. denied, 498 U.S. 983 (1990); *Securities Industry Assoc.* v. *Connolly*, 883 F.2d 1114, 1120 (1st Cir.), cert. denied, 495 U.S. 956 (1990); *Webb* v. *R. Rowland & Co.*, 800 F.2d 803, 806-807 (8th Cir. 1986).



and which treats arbitration as a disfavored forum, surely stands as an obstacle to the effective implementation of the congressional purpose. As the Seventh Circuit recently noted, "[s]tate common law hostile to arbitration is preempted by federal common law friendly to it." *Baravati*, 28 F.3d at 711.

So far as the FAA is concerned, "parties are generally free to structure their arbitration agreements as they see fit," and they may limit by contract such matters as the issues they will arbitrate or the rules under which the arbitration will be conducted. *Volt*, 489 U.S. at 479. The Act therefore would not prevent the parties from expressly agreeing that punitive damages would not be awardable in any dispute between them, or from accomplishing the same result by inserting explicit contractual language to the effect that resolution of disputes between the parties "will be governed by New York law, including the limitation on arbitral power announced in *Garrity*." But the customer agreement here does not expressly say that punitive damages are not allowed, nor does it reference the *Garrity* rule; it says only that New York law governs. Standing alone, the choice-of-law provision should not be read to incorporate state law principles that would be preempted if New York law applied of its own force as a result of the State's connection to the relevant primary conduct.[18]

[18] This Court's decision in *Volt* is not to the contrary. The arbitration agreement at issue in *Volt* included a choice-of-law provision that referenced California law. Because the California Arbitration Act authorized "a court to stay arbitration pending resolution of related litigation" (489 U.S. at 470), the case had proceeded directly in the state courts, rather than on review of an arbitral award. The California Court of Appeal interpreted the choice-of-law provision to incorporate California rules of arbitration, including the statu-

d. For the foregoing reasons, the arbitrators in this case acted well within their province in interpreting the parties' agreement as not incorporating the *Garrity* rule. The courts below therefore erred in setting aside the award of punitive damages.

---

tory provision empowering a state trial court to stay arbitration. *Id.* at 471-472. This Court declined to revisit the state court's construction of the arbitration agreement, *id.* at 474-476, noting that "the interpretation of private contracts is ordinarily a question of state law, which this Court does not sit to review." *Id.* at 474. The Court then held that, "assuming the choice-of-law clause meant what the Court of Appeal found it to mean," *id.* at 476, application of the stay provision was not preempted by the FAA. *Id.* at 476-479.

*Volt* does not cast doubt upon our contention that the agreement in the instant case was permissibly interpreted by the arbitrators to allow an award of punitive damages. Nothing in *Volt* suggests that respondents' construction of the agreement here is the correct one, much less that an arbitral award grounded in a contrary reading was properly vacated by the district court. Moreover, the California procedural rules at issue in *Volt* merely provided that the trial court could coordinate the timing of an arbitration proceeding and a parallel state court lawsuit involving third parties. This Court found that incorporation of the California procedural rules was not inconsistent with the FAA because those rules were "manifestly designed to encourage resort to the arbitral process." 489 U.S. at 476. In contrast to the state procedural rules applied in that case, the *Garrity* rule discourages resort to the arbitral process by depriving plaintiffs of an otherwise available substantive remedy.



## CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

DREW S. DAYS, III
*Solicitor General*

SIMON M. LORNE
*General Counsel*

LAWRENCE G. WALLACE
*Deputy Solicitor General*

PAUL GONSON
*Solicitor*

MALCOLM L. STEWART
*Assistant to the Solicitor General*

JACOB H. STILLMAN
*Associate General Counsel*

LUCINDA O. MCCONATHY
*Assistant General Counsel*

SUSAN S. MCDONALD
*Special Counsel*

MARK PENNINGTON
*Special Counsel*
*Securities and Exchange Commission*

NOVEMBER 1994

☆ U. S. GOVERNMENT PRINTING OFFICE: 1994 387147 20009